BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CLAYTON B. AND DOROTHY M. NEILL)

For Appellants: Elwood J. Wilson
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Lawrence C. Counts
Assistant Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Clayton B. and Dorothy M. Neill against proposed assessments of personal income tax in the amounts of $199.51, $307.51, and $273.64 for the years 1960, 1961, and 1962, respectively.

The question presented by this appeal is: To what extent may the owner of an unincorporated public utility deduct depreciation on property constructed with third-party advances which are only conditionally refundable?

Appellants herein are husband and wife. During the year 1952 they acquired ownership of Bolsa Knolls Water Company (hereinafter referred to as "Bolsa") and in 1955 they acquired ownership of Rancho Del Monte Water Company (hereinafter referred to as "Rancho"). Bolsa and Rancho are unincorporated Class "D" public utilities subject to regulation by the Public Utilities Commission (hereinafter referred to as the "Commission").

Subsequent to the year 1955 appellants constructed certain water main extensions for the Bolsa and Rancho operations, utilizing noninterest bearing funds advanced by

subdivision developers and builders desiring water service for prospective purchasers of houses and lots. Commission rules provided that the advances were to be refunded over a specified term of years by the "percentage of revenue" or "proportionate cost" methods. Under either method the amount of the actual refund was dependent upon the extent of future customer service from the main extensions. The requirement to refund was to terminate at the end of the prescribed term of years regardless of whether the total amount of funds advanced had been refunded. (53 Cal. P.U.C. 490, 499, et seq.) The Bolsa advances were to be refunded over a 20-year period and the Rancho advances were to be refunded over a lo-year period.

Title to the water main extensions passed to the utilities upon completion of construction. In accordance with accounting procedures prescribed by the Commission the main extensions were classified as depreciable assets and the utilities accumulated depreciation on the total cost thereof. The amount of the depreciation thus computed was deducted by appellants in determining the net income from the operation of Bolsa and Rancho for federal and state income tax purposes.

The United States Internal Revenue Service conducted an audit of the operations of Bolsa and Rancho and disallowed deductions taken for depreciation on the water main extensions financed by the advances and made certain other adjustments which were not contested. These adjustments resulted in an increase in appellants' taxable income for federal income tax purposes. Respondent issued deficiency assessments based upon the adjustments made by the federal tax agency.

Appellants filed objections to the deficiency assessments contending that (1) the determination made by the federal agency was not controlling for state tax purposes, and (2) respondent was bound by the Commission's determination that depreciation was deductible on the cost of the water main extensions. Respondent contends that depreciation deductions can be taken for income tax purposes only on the basis of refunds made to the subdivision developers and builders.

Section 17208 of the Revenue and Taxation Code allows a depreciation deduction:

> ... for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)-- (1) of property used in the trade or business.....

With certain exceptions which have no application here, the basis of the allowance for exhaustion, wear and tear, and obsolescence is the cost of the property. (Rev. & Tax. Code,

§§ 17211, 18041, 18042.) These statutory provisions were patterned after and are virtually identical in wording with the federal depreciation provisions now found in section 167(a), 167(g) and sections 1011 and 1012 of the United States internal Revenue Code of 1954.

We recognize that administrative application of a federal tax law is not binding for state tax purposes. However, judicial construction of the federal law is entitled to considerable weight where the state statute is based upon the federal law. (Innes v. McColgan, 47 Cal. App. 2d 781 [118P.2d 855].) We find no difference in the application of the state and federal law to the facts of this appeal.

The essence of depreciation is the setting aside of a fund to account for the gradual economic loss incurred through the exhaustion, wear and tear, and obsolescence of the property. (4 Mertens, Law of Federal Income Taxation, § 23.01 .) To be afforded a tax deduction for depreciation the taxpayer's capital investment in the property must be in existence and fixed as to amount so that the basis for the depreciation is ascertainable. (Detroit Edison Co., 45 B.T.A. 358, aff'd, 131 F.2d 619, aff'd, 319 U.S. 98 [87 L. Ed. 1286]. See also, Las Vegas Land & Water Co., 26 T.C. 881.)

It is evident in this case that the initial capital outlay was provided by the persons advancing funds and that appellants' obligation to refund any portion thereof was contingent upon the happening of future events. There was no method by which the amount of appellants' obligation could have been ascertained prior to the time the refunds became due. For this reason we must conclude that appellants' investment in the property did not come into existence and was not fixed except as refunds were made or required to be made. Only as refunds were made or became due and to the extent of the refunds did the utilities acquire a depreciable basis in the assets. (Elizabethtown Water Co. Consolidated, 7 T.C. 406; Detroit Edison Co. v. Commissioner, supra.)

Appellants have advised that new rules promulgated by the Commission on November 8, 1962, provided for the substitution of new contracts, requiring ultimate repayment of the entire amount of the advances. The substitution of the new contracts, however, was not mandatory. (60 P.U.C. 318, 331.) There is no evidence in the record that petitioner entered into such new contracts during the years here considered.

The disallowance of the depreciation deductions is fully supported by judicial authorities in the area of taxation. Respondent Franchise Tax Board, the agency charged with administration of the Personal Income Tax Law, is not bound by the accounting ruies prescribed by the Commission for purposes other

than taxation. (Rev. & Tax. Code, § 19451.) It is settled that a taxpayer may be required to account differently to different government agencies where the information is required for divergent purposes. (National Airlines, Inc., 9 T.C. 159; Bellefontaine Federal Savings & Loan Ass'n., 33 T.C. 808; Appeal of People's Federal Savings & Loan Ass'n., Cal. St. Bd. of Equal., June 24, 1957.)

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Clayton B. and Dorothy M. Neil.1 against proposed assessments of additional personal income tax in the amounts of $199.51, $307.51, and $273.64 for the years 1960,1961, and 1962, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 24th day of April, 1967, by the State Board of Equalization.

Paul R. Leake, Chairman

John W. Lynch, Member

Member

Member

Member

Attest: , Secretary